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No. 84-612

In the Supreme Court of the United States

OCTOBER TERM, 1984

JAMES W. YARBRO AND MARY E. YARBRO,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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Petitioners challenge the court of appeals' holding that certain real estate constituted a "capital asset" and that their abandonment of that real estate to the mortgagee constituted a "sale or exchange," thereby resulting in a capital loss rather than an ordinary loss for tax purposes.

1. In 1972, petitioner James Yarbro[1] and five other individuals formed a joint venture for the purpose of acquiring a parcel of undeveloped land near Fort Worth, Texas. The purchase price was $362,132. About 10% was paid in cash, the balance being covered by nonrecourse promissory notes secured by deeds of trust on the property. Petitioner took title to the property as trustee. Pet. App. B6.

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[1] Petitioner Mary Yarbro is married to James and is a party to this case solely by virtue of having filed a joint return with her husband for the tax year at issue.

The property was subject to a livestock grazing lease at the time petitioner's group acquired it, and the joint venturers continued to rent the land for grazing purposes while they owned it. The annual rental income that the joint venture received was about $1,000. Its only other income was a nominal amount of interest. The joint venture incurred expenses of about $23,000 annually, mainly for interest, taxes and insurance in connection with the property. Pet. App. B7-B8.

One of petitioner's primary reasons for buying the property was the expectation that it would appreciate in value and that it could be sold at a later date for a substantial profit (Pet. App. B8). Although the possibility of developing the property was considered, no definite development plans were drawn up, no improvements were ever made, and the joint venture participants were never asked to advance funds for that purpose (*ibid.*). The joint venture's investment nature was confirmed shortly after it acquired the property, when petitioner, in electing to have the joint venture excluded from taxation under the partnership provisions of the Internal Revenue Code,[2] recited that the joint venture was "an investing partnership" (Pet. App. B34). A real estate joint venture generally qualifies for that election only if it is availed of "for investment purposes only and not for the active conduct of a business" (I.R.C. § 761(a)(1)).

In 1976, the City of Fort Worth proposed to increase the real estate taxes on the joint venture's property by 435%. At about the same time, real estate activity in the area became moribund. By November 1976, the property's fair market value had dropped below the face amount of the nonrecourse mortgage that encumbered it. Faced with these facts, the joint venturers de-

[2] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.)

cided to abandon the property rather than pay the 1976 taxes and interest. Petitioner, as trustee, notified the bank which held the mortgage that he was abandoning the realty. The bank requested that he reconvey the property to it, but petitioner refused. Pet. App. B8-B9. In June 1977, the bank obtained title to the property through foreclosure (*id.* at B10).

On his 1976 federal income tax return, petitioner claimed an ordinary loss of $10,376—the amount of his cash investment—on abandonment of the joint venture property (Pet. App. B10). The Commissioner on audit determined that petitioner's loss was not an ordinary loss fully deductible against his income, but rather was a long-term capital loss arising from the sale or exchange of a capital asset. The Tax Court sustained that determination (Pet. App. A1-A13). It found as a fact that petitioner had acquired his interest in the property for investment purposes, rather than for use in a trade or business, and hence that the property was a "capital asset" in his hands (*id.* at A6-A10). And it held that the joint venture's abandonment of the property constituted a "sale or exchange" for federal tax purposes (*id.* at A10-A11). The court of appeals unanimously affirmed (*id.* at B1-B38).

2. Section 165(a) of the Code provides, as a general rule, that taxpayers may deduct "any loss sustained during the taxable year and not compensated for by insurance or otherwise." The application of this general rule, however, is limited by Section 165(f). It provides that losses arising from "sales or exchanges of capital assets" are deductible only as capital losses. Capital losses are subject to limitations on their deductibility that do not apply to ordinary losses.

Petitioner contends (Pet. 40-46) that the joint venture property was not a "capital asset" on the theory that it was used in the trade or business of renting property. The Tax Court resolved this factual question

against petitioner, relying principally on his demonstrated investment objectives and the nominal character of the annual rent (Pet. App. A7-A10). The court of appeals held that the Tax Court's factual findings were not clearly erroneous (*id.* at B31-B35), and there is no basis for further review of that determination.

Petitioner alternatively contends (Pet. 18-41) that, even if the property was a "capital asset," his abandonment of it to the bank was not a "sale or exchange" and hence must generate an ordinary loss. Every court that has squarely addressed this question, however, has held, consistently with the Fifth Circuit here, that the surrender to a mortgagee of property encumbered by nonrecourse debt is a "sale or exchange" for tax purposes. *Middleton* v. *Commissioner*, 693 F.2d 124 (11th Cir. 1982); *LaPort* v. *Commissioner*, 671 F.2d 1028 (7th Cir. 1982); *Freeland* v. *Commissioner*, 74 T.C. 970 (1980). The courts in *LaPort* and *Freeland* concluded that a voluntary conveyance in lieu of foreclosure—effected by a quitclaim deed from the mortgagor to the mortgagee—is a "sale or exchange," notwithstanding that the mortgagor (as here) was not personally liable on the mortgage note and received no consideration other than release from that nonrecourse liability (671 F.2d at 1033-1034; 74 T.C. at 975-982). The court in *Middleton* similarly concluded that a voluntary abandonment by the mortgagor to the mortgagee of property subject to nonrecourse debt is a "sale or exchange" generating a capital loss (693 F.2d at 125).

These courts noted that their holdings were the "logical extension" of this Court's holdings in *Helvering* v. *Hammel*, 311 U.S. 504 (1941), and *Helvering* v. *Nebraska Bridge Supply & Lumber Co.*, 312 U.S. 666 (1941), where the Court ruled that the term "sale or exchange" should be broadly construed to encompass involuntary foreclosures by a mortgagee, whether or not the mortgagor is personally liable. See 671 F.2d at 1033; 74 T.C. at 977, 980-981. As the court below observed (Pet. App. B17), the ordinary meaning of "ex-

change" suggests the act of giving one thing for another thing regarded as equivalent. Here, by abandoning the joint venture property, petitioner relinquished all claim to it in return for being relieved of paying the face amount of the mortgage encumbering it. That transaction was plainly an "exchange" in the usual sense of the word.

The court of appeals also noted correctly (Pet. App. B24-B28) that common sense mandates a consistency of results between this case and the other cases discussed above. Practically speaking, the consequences to the delinquent mortgagor are identical regardless of whether the property encumbered by nonrecourse debt is involuntarily foreclosed by the mortgagee (as in *Hammel* and *Nebraska Bridge*), voluntarily conveyed by quitclaim deed to the mortgagee (as in *LaPort* and *Freeland*), or voluntarily abandoned to the mortgagee, who subsequently forecloses without opposition (as in *Middleton* and the instant case). In each situation, the mortgagor receives the same "consideration"—relief from the nonrecourse liability, without more—and there is no reason to treat one form of the transaction as any less a "sale or exchange" than any one of the other forms. Indeed, as the court of appeals emphasized, the tax consequences of a transaction are dictated by its substance and not its form, and petitioner "should not be allowed to avoid the limitations on deductions for capital losses by using an artfully timed abandonment rather than a sale, voluntary reconveyance, or foreclosure" as the mechanism he chooses for relinquishing his interest to the mortgagee. Pet. App. B27. See *Harrison* v. *Schaffner*, 312 U.S. 579, 582 (1941); *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613 (1938).[3]

[3] Contrary to petitioner's contention (Pet. 18-21), nothing in Treas. Reg. § 1.165-2(a) mandates a different result. That regulation generally provides that "[a] loss incurred * * * from the sudden termination of the usefulness * * * of any non-

Finally, the court of appeals' result is strongly supported by this Court's decision in *Commissioner* v. *Tufts*, 461 U.S. 300 (1983). That case, like this one, involved a taxpayer's transfer of property subject to a nonrecourse mortgage that exceeded the property's fair market value. There, as here, the taxpayer received no appreciable consideration for the transfer other than release from that nonrecourse liability (461 U.S. at 303). This Court held that the taxpayer had to include the entire amount of the nonrecourse debt in his "amount realized" for purposes of computing his gain or loss on the transfer (*id.* at 309-310).

That holding shows the correctness of the Fifth Circuit's holding here. If the nonrecourse debt is part of the taxpayer's "amount realized," obviously, release from that nonrecourse debt must constitute "consideration" to the taxpayer and thus qualify the transaction—be it a voluntary conveyance, foreclosure, or abandonment—as a "sale or exchange." See Pet. App. B20-B21.[4]

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depreciable property * * * where such property is permanently discarded from use * * * shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained." As the court of appeals noted (Pet. App. B29-B30), this regulation by its terms relates only to the *timing* of deductions for an abandonment loss, not to the *character* of the loss as capital or ordinary. See *LaPort*, 671 F.2d at 1031 n.5.

[4] Petitioner seeks to blunt the force of *Tufts* by asserting (Pet. 8-9, 22, 34) that he did not record the nonrecourse mortgage on his books of account or include it in his basis for the property. Petitioner cites no support in the record for this assertion, and we know of none. In any event, the relevant question is not whether petitioner *actually included* the nonrecourse debt in his basis, but whether that nonrecourse debt was *properly to be included* in his basis. See Treas. Reg. § 1.1001-2(a)(3). As this Court noted in *Tufts*, the nonrecourse debt must necessarily become part of the mortgagor's basis, since, the mortgagee not being entitled to it, there is nowhere else for it to go. See 461 U.S. at 308 n.5 (second paragraph).

3. Petitioner errs in asserting (Pet. 27-33) that the circuits are in conflict on the question presented here. Petitioner places primary reliance (*id.* at 27-29) on *Hoffman* v. *Commissioner*, 40 B.T.A. 459 (1939), aff'd per curiam, 117 F.2d 987 (2d Cir. 1941) As the Fifth Circuit observed below (Pet. App. B13-B14), however, the Second Circuit in *Hoffman* did not squarely address the question whether an abandonment constitutes a "sale or exchange" for tax purposes. The same can be said of all the other cases upon which petitioner relies,[5] which either did not address the issue or merely assumed (without deciding) that an abandonment of property results in an ordinary loss.[6] In any event, all these cases were decided before this Court's seminal decision in *Crane* v. *Commissioner*, 331 U.S. 1 (1947), where the Court first held that relief from nonrecourse indebt-

[5] See Pet. 28-33, citing *Denman* v. *Brumback*, 58 F.2d 128 (6th Cir. 1932); *Bickerstaff* v. *Commissioner*, 128 F.2d 366 (5th Cir. 1942); *Commissioner* v. *Green*, 126 F.2d 70 (3d Cir. 1942); *Helvering* v. *Jones*, 120 F.2d 828 (8th Cir. 1941); and *Blum* v. *Commissioner*, 133 F.2d 447 (2d Cir. 1943).

[6] *Helvering* v. *Flaccus Leather Co.*, 313 U.S. 247 (1941), also cited by petitioner (Pet. 36-38), is not in point. The question there was whether the destruction by fire of fully-depreciated property (buildings, machinery and equipment) used in the taxpayer's trade or business constituted a "sale or exchange" within the meaning of Section 117(d) of the Revenue Act of 1934, 48 Stat. 715. This Court held that the involuntary conversion was not a "sale or exchange," and hence that the insurance proceeds received by the taxpayer were taxable as ordinary income (313 U.S. at 251). In so holding, obviously, the Court expressed no view as to the result that would obtain from the *voluntary* abandonment of *nondepreciable* real estate that is *not* used in the taxpayer's trade or business, the situation presented here. In any event, Congress amended Section 117(d) of the 1934 Revenue Act shortly after *Flaccus Leather* was decided in order to provide for capital gain treatment of involuntary conversions of the sort there involved. See I.R.C. § 1231; H.R. Rep. 2333, 77th Cong., 2d Sess. 96-97 (1942).

edness must be taken into account for tax purposes. Whatever inferences might once have been drawn from *Hoffman* and the other cases petitioner cites, the precedential effect of those decisions was dissipated by *Crane*, which anticipated this Court's decision in *Tufts* and which the Court in *Tufts* found "controlling." See 461 U.S. at 304.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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